

United States Department of State

# Hungarian Economic Reform: Status and Prospects

September 1989

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### **Summary**

Hungary has made genuine progress on some aspects of economic reform, but its financial position is becoming increasingly precarious because of backsliding on its much touted austerity and reform program for 1988-90, slow progress on reducing subsidies, and heavy spending by Hungarians taking advantage of relaxed travel rules. Although Budapest will not have to reschedule its foreign debt this year, a large current account deficit will add to its growing debt service burden and increase the already high risk of future debt servicing problems—problems that will pose additional challenges for the country's leadership as it tries to manage the difficult transition to a more democratic political system.

The economy's current troubles are not new. Economic problems beginning in the late 1970s have caused the Hungarian economy to struggle with sluggish growth, stagnant living standards, an increasingly obsolescent industrial base, and a rising foreign debt burden. These problems have their roots in the imposition of the Soviet economic model in the late 1940s—with inordinate emphasis on heavy industry—and the reorientation of a major share of Hungarian trade to the generally less demanding Soviet market. Meanwhile, the economy's adjustment to changes in world markets and to growing international competition has been slowed by macroeconomic policy errors, poor use of foreign loans, and inconsistent implementation of economic reforms.

To address the shortcomings of previous reform efforts and lay the basis for improved economic performance, the Hungarian Government has been trying to increase the role of market forces in the economy since late 1986. Over the past three years, it has legislated a broad range of measures to free the economy from administrative dictate, develop capital markets, and stimulate more efficient use of resources. These measures include reorganizing the banking system and introducing new financial instruments, creating a new tax system, expanding the scope of private and foreign investment, and establishing bankruptcy mechanisms. The government has also been moving gradually toward market-based wages and prices. Other ongoing reform efforts focus on better integrating the economy into world markets in order to expose Hungarian producers to greater competition and accelerate industrial restructuring. Last January, for example, the government took the first

steps toward a freer import regime, and it is currently evaluating the likely benefits and costs of placing trade with the Soviet Union on a hard currency basis.

Although these reforms go further than measures adopted elsewhere in Eastern Europe and are more comprehensive than any previous Hungarian efforts, they have had a limited impact on performance. Budapest continues to subsidize loss-making activities, fearing the social and economic dislocations associated with letting insolvent state enterprises fold. A relatively broad consensus on the need to accelerate the reform process appears to be forming among party reformers and many of the opposition parties. The leadership, however, will probably find it difficult to mount any major reform drive until after the multiparty parliamentary election scheduled to take place by June 1990.

In the meantime, the Hungarian Government has begun to look more toward Western governments to help put its economy on a sounder economic footing. The most significant contributions the West can make to Hungary's economic well-being are to provide technical and managerial expertise in a host of areas—including developing capital markets and a service infrastructure for the private sector, improving enterprise management, establishing foreign sales networks, and retraining large numbers of workers—and to encourage foreign investment in Hungary. Financial assistance can also help maintain reform momentum, but only if it is tied to specific projects or performance criteria to ensure that it is not used merely for financing consumption or for keeping ailing enterprises afloat.

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## **Hungarian Economic Reform: Status and Prospects**

### **Introduction**

Pressed by a dismal economic performance in the first half of 1989, growing vulnerability to a debt rescheduling, and popular opposition to further austerity, the Hungarian Government has begun to look more toward Western governments to help put its economy on a sounder footing. To better understand where Western aid would be most effective in helping Hungary manage a relatively smooth and peaceful transition toward a more market-oriented economy and a more democratic political system, this paper will examine the nature and sources of Hungary's current economic problems. This background will lead to a summary of the progress made in various areas of reform that are vital to promoting greater productivity and a sustainable economic recovery. Finally, the paper will assess the prospects for further reform and look more specifically at what Western governments can do to nudge this process forward.

### **Growing Sense of Crisis**

This year, backsliding on Hungary's much touted austerity and reform program for 1988-90, slow progress on phasing out subsidies, and heavy spending by Hungarians taking advantage of relaxed travel rules have made Hungary's financial position increasingly precarious and contributed to popular perceptions, prevalent since at least 1986, that the economy is in crisis. The leadership has been reluctant to take measures that could lower the standard of living or create unemployment because it must compete sometime before next June in Hungary's first free parliamentary election since 1948. Thus, efforts to shift resources from established, but ailing, industries—in particular, steel and coal mining—to newer, more competitive firms have continued to proceed slowly, and industrial growth faltered in the first half of the year, falling 0.7 percent. At midyear, the budget deficit, money supply, and current account deficit had all exceeded targets established in conjunction with the International Monetary Fund (IMF), while Hungary's foreign exchange reserves dropped to an uncomfortably low level of less than three months' worth of

imports. Inflation—at 18 percent—was also higher than planned, but household incomes kept pace, rising about 2 percent in real terms as compared with a planned decline under the austerity program.

Despite these worsening indicators, Hungary has not had any serious difficulties raising needed credits in international capital markets and probably will avoid debt servicing problems this year—even if it fails to reduce the current account deficit from its current level of nearly \$1 billion to a revised target of \$600 million. Financing a larger-than-planned deficit, however, will add to Hungary's future debt service burden and increase its vulnerability to a debt rescheduling. Hungary is already at great risk of future debt servicing problems because of sharply rising debt service costs in the early 1990s and the low export competitiveness of its economy.

If at any time commercial bankers lose confidence in Budapest's economic management and cut short-term credit lines—as they did in 1982—Hungary would probably have to reschedule its foreign debt within a few months. Budapest usually carries at least \$2 billion in short-term debt to finance trade and other transactions; without this funding, hard currency reserves—now just \$1.2 billion—would be quickly depleted. The possibility of a rescheduling would increase significantly if climbing interest rates raised debt service costs and caused a recession in the West that reduced demand for Hungarian exports. It would also increase if world prices for some of Hungary's key hard currency exports, including aluminum, agricultural commodities, and petroleum-based products, softened.

A rescheduling probably would temporarily set back Hungary's reform efforts, unless Western governments and international financial institutions guaranteed a continued flow of new credit. Without such assistance, Budapest's ability to borrow on commercial money markets would be limited, requiring a severe reduction in imports as well as tougher austerity measures. As a result, Budapest would

be more cautious initially about implementing major reforms, such as currency convertibility, that could lead to a short-term deterioration in its external accounts. Also, the government probably would suspend previous measures, such as the removal of administrative controls on imports and liberalized access to hard currency for private citizens. Because most of the leadership recognizes the need for a more market-based economy, however, a rescheduling probably would not erode Budapest's commitment to reform in the longer term.

### **Sources of Hungary's Economic Woes**

The economy's current troubles are not new. Since the late 1970s, the Hungarian economy has struggled with sluggish growth, stagnant living standards, an increasingly obsolescent and uncompetitive industrial base, and a rising foreign debt burden. These problems stem in large part from deep-seated structural problems:

- Overemphasis on heavy industry and energy. Heavily subsidized industries—mining and ferrous metallurgy are prime examples—are a serious drain on the budget. Moreover, productivity growth in most manufacturing branches is below international norms, limiting Hungary's export potential and ability to service its foreign debt.
- Weaknesses in the agricultural sector. Even agriculture, long considered Hungary's success story, has accrued mounting losses in the face of reduced subsidies and input costs that are rising faster than final sales prices.
- The high degree of monopolization and unnecessary vertical integration. Too many large monopolistic enterprises are protected from competition and bankruptcy by vested interests in the party and government bureaucracies. In addition, many components are inefficiently produced within enterprises because factory managers seek to be as self-sufficient as possible and because there are few small and medium-sized supplier industries that produce common components in bulk.
- A neglected infrastructure. The deficiencies of the telecommunications system in particular make it difficult to conduct business on a timely basis.

- Low technological development. Reliance on centralized R & D institutes and a tendency to focus more on fundamental than applied research have slowed both product development and the assimilation of foreign technologies.

Recent Hungarian Government studies attribute the economy's problems to the imposition of the Soviet economic model in the late 1940s and reorientation of a major share of Hungarian trade to the generally less demanding Soviet market. While these factors as well as unfavorable external developments undoubtedly have played an important role, macroeconomic policy errors, poor use of foreign loans, and inconsistent implementation of economic reforms have slowed the economy's adjustment to changes in world market demand and prices and to growing international competition.

### **Macroeconomic Policy Errors**

Hungary is again on the verge of financial crisis in part because of the legacy of misguided efforts to grapple with its persistent balance-of-payments problems. Reliance on administrative measures, such as import and investment controls, to cope with these problems in the first half of the 1980s appeared prudent initially because high rates of investment in the 1970s had inflated demand for Western imports, leading to trade imbalances and a sharp rise in foreign borrowing. The 20-percent cumulative decline of investment between 1979 and 1985, however, held back the establishment of new ventures and the modernization of potentially dynamic enterprises. As a result, the average age of manufactured product designs is now about 16 years, while the share of designs under three years old is less than 15 percent, according to the Hungarian Chamber of Commerce. Modernization efforts were further hindered by the fact that the share of investment in the energy and basic materials sectors rose from 14.7 percent in 1976-80 to 17.9 percent in 1981-85, while the share of manufacturing declined from 20.9 percent to 16.3 percent. The resulting limited change in the sectoral shares of industrial output, employment, and capital stock since 1975 illustrates the lack of structural adjustment (see table 1).

**Table 1**  
**Hungary: Branch Structure of Industry**

*Percent share*

	Output		Employment		Fixed Assets	
	1975	1987	1975	1987	1975	1987
Total heavy industry	67.8	69.6	58.6	60.6	75.4	77.2
Mining	9.2	6.9	7.2	7.7	9.0	10.8
Electric energy	5.1	6.0	2.2	2.9	15.2	19.9
Metallurgy	10.0	8.0	6.0	5.7	10.8	9.0
Engineering	24.0	25.9	31.6	32.3	17.6	17.0
Machinery	6.1	5.8	8.7	8.5	4.0	3.8
Vehicles	6.9	7.1	6.2	6.4	5.6	5.0
Electrical engineering	3.1	3.3	3.4	3.8	2.1	2.0
Telecommunications	2.7	4.7	5.6	6.5	2.6	3.0
Precision engineering	1.7	2.5	3.3	3.6	1.3	1.5
Metal products	3.4	2.4	4.4	3.5	2.0	1.6
Building materials	3.2	3.3	4.8	4.5	6.9	5.3
Chemicals	16.3	19.5	6.8	7.5	15.9	15.2
Light industry	14.4	12.9	26.4	22.7	12.2	9.9
Miscellaneous	1.0	0.9	3.6	2.5	1.1	0.6
Food	16.8	16.6	11.4	14.2	11.3	12.3

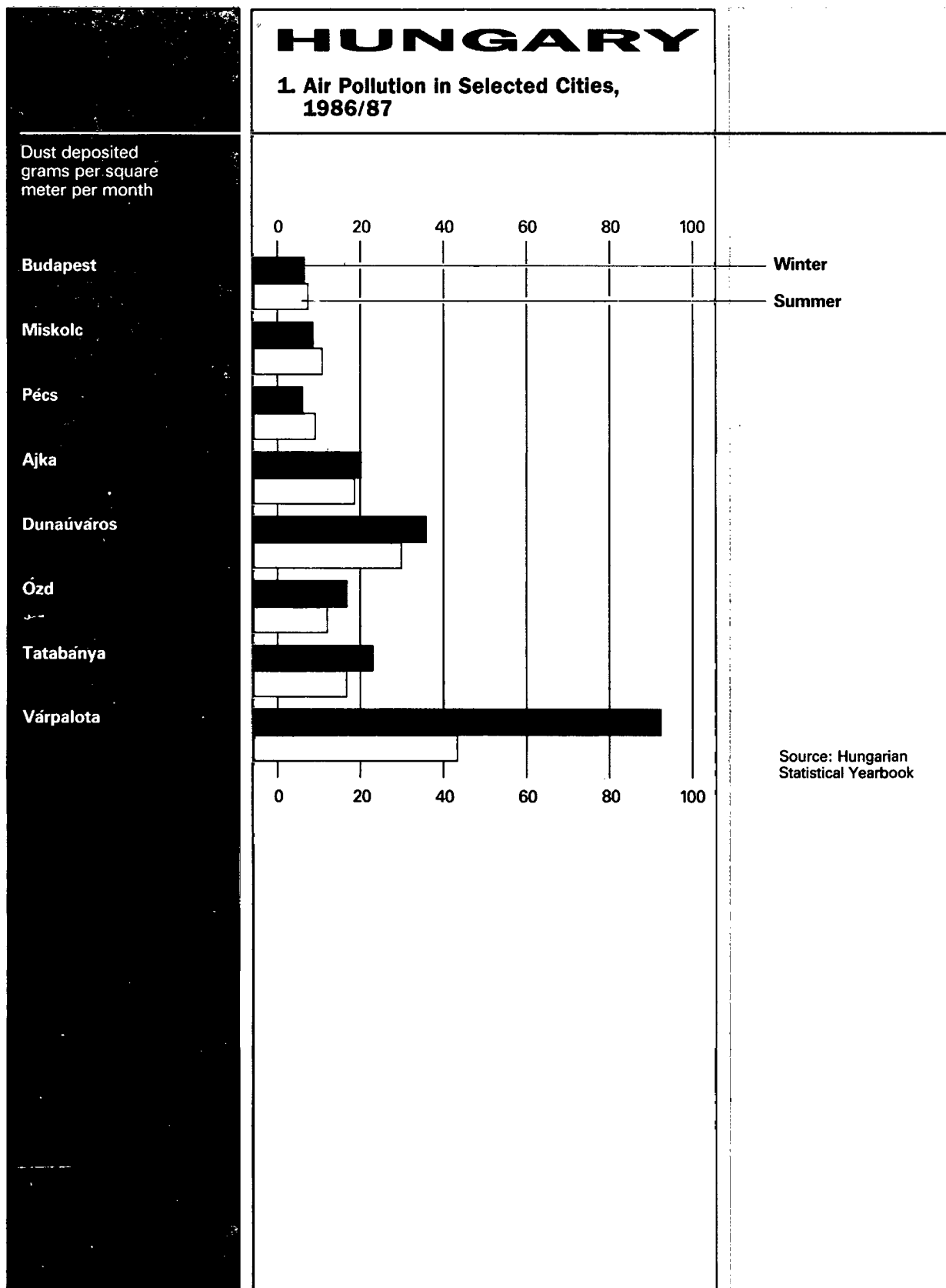
Source: Hungarian Statistical Yearbook.

Substantial investment in energy production, moreover, has neither increased output—with the exception of nuclear power, which still accounted for less than 15 percent of domestic energy production in 1987—nor improved efficiency significantly. Investment in oil, coal, and gas production has had limited payoff because of the small size of reserves, complex geological conditions, a shortage of hard currency to acquire modern technology for deep drilling, and Western restrictions on the export of advanced technology. Hungarian planners expect only a slight increase in natural gas extraction and the leveling off of petroleum and coal output in the next decade.

Policymakers have tried to encourage conservation with preferential loan programs, but growth in energy productivity has slowed since 1982, and efforts to conserve energy have been less effective than in the West. Easy conservation gains may have been exhausted in the early 1980s, and energy productivity has probably suffered from the increasing obsolescence of Hungary's industrial base. Greater conservation savings as well as lower air pollution

levels could have been achieved if more investment had gone toward modernizing production facilities and restructuring the economy away from energy intensive sectors, such as metallurgy, and if policymakers had stopped subsidizing household energy prices (see figure 1).

The restrictions on investment and imports, nonetheless, produced sizable current account surpluses in 1983-84, which helped Hungary regain access to commercial credit after near bankruptcy in 1982. Hungarian policymakers concluded they had weathered their financial problems and could shift priorities back to economic growth. Thus, Budapest loosened controls on domestic credit, government spending, and imports. But, because export industries were uncompetitive and agriculture was adversely affected by several years of poor weather, economic performance fell far short of plan and payments imbalances reemerged. GNP growth averaged only 0.1 percent annually in 1985-87, while higher-than-planned growth in



investment and consumption—coupled with pent-up demand for Western capital and consumer goods—led to a surge in hard currency imports and the reemergence of large current account deficits (see figure 2).

The hard currency trade balance swung from a \$1.2 billion surplus in 1984 to a \$540 million deficit in 1986 and, along with rising interest charges on debt, pushed the current account deficit to a record \$1.4 billion. In 1987 and 1988, austerity policies, coupled with an export drive and an upswing in world prices for Hungary's metallurgical and agricultural exports, helped narrow the deficit, but the improvement was less than the government was aiming for (see figure 3). Financing these large deficits, in turn, hiked Hungary's hard currency foreign debt from \$8.8 billion in 1984 to its current level of about \$17 billion.

#### **Poor Debt Management**

Hungary is extremely vulnerable to a debt rescheduling because the leadership has allowed its foreign debt to rise much too rapidly in comparison with the economy's capacity to repay the loans; much of the borrowing went to shield consumers from austerity and industry from painful restructuring. As a result, Hungary now has the highest per capita debt in Eastern Europe and is devoting a greater share of its hard currency earnings to debt service than any other East Bloc country. Hungarian Trade Ministry officials estimate that Hungary's future financing needs—debt principal repayments and net interest payments—will amount to \$11.1 billion over the 1990-92 period, \$8-9 billion of which they expect will need to be covered by loans from the World Bank, the IMF, and commercial banks.

Because it has given top priority to servicing its debt, Hungary has better access to commercial credits than does Poland and each year is able to roll over most of its maturing principal. Nonetheless, debt service costs probably will exceed 40 percent of hard currency goods and service earnings through at least 1992. Such high obligations severely limit resources for investment and have led the leadership to push exports to the West, even at the cost of subsidizing unprofitable exporters.

#### **Shortcomings of the Reform Process**

The Hungarian economy is not performing up to the high expectations created by its reform efforts. The watering down of successive initiatives and insufficient understanding of how a market economy functions have left some of

the fundamental flaws of central planning largely intact and failed to create adequate incentives for promoting industrial restructuring. Reforms have focused mainly on decentralizing decisionmaking in state enterprises and only selectively on injecting market forces into the economy. In the first half of the 1980s, Budapest broke up some large enterprises into smaller units, merged ministries responsible for specific industries into a single Ministry of Industry, and introduced various other measures, including a type of worker self-management, to increase enterprise autonomy. In addition, it allowed private and cooperative ventures gradually to expand the scope of their activities. The leadership, however, never intended to go further than merely improving the functioning of its centrally planned economy and, until recently, did not recognize the need to develop true capital and labor markets to promote greater efficiency.

In the absence of genuine markets, the authorities have moved from setting plan targets to creating a set of frequently modified "regulators"—including subsidies, wage and price rules, and taxes—designed to simulate the workings of a market. The same bargaining between enterprises and the state that had occurred over plan targets has continued over the regulators, undermining their effectiveness. In addition, tax breaks and subsidies to ailing enterprises, which the leadership has not had the political will to close, have conflicted with efforts to promote profit-mindedness among managers and more efficient resource allocation. Moreover, the bureaucracy's constant tinkering with reform and its attempts to make the system work with a plethora of enterprise-specific regulations and exemptions have created an atmosphere of uncertainty for enterprise managers, leading them to spend surplus funds quickly and to develop a short-term horizon for planning and investment decisions.

#### **Renewed Emphasis on Reform**

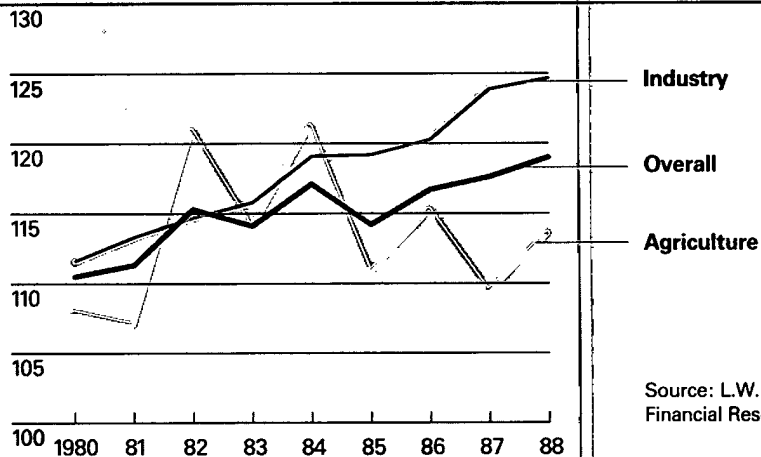
To address the shortcomings of previous reform efforts and lay the basis for improved economic performance, the Hungarian Government has been trying to increase market forces in the economy since late 1986. Over the past three years, it has legislated a wide range of measures to free the economy from administrative dictate and to develop capital

# HUNGARY

## 2. Selected Growth Indicators

### Selected GNP Indices, 1980-88

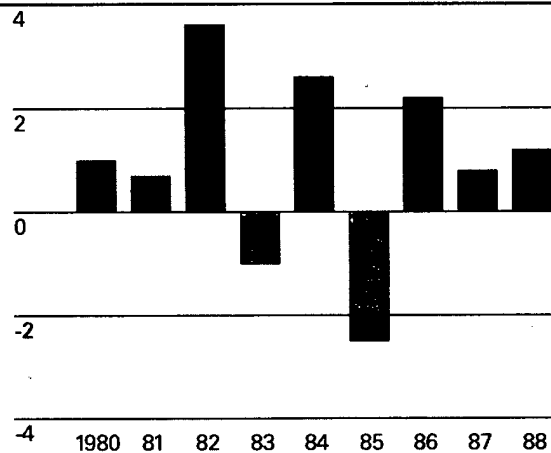
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Source: L.W. International Financial Research, Inc.

### Real GNP Growth, 1980-88

Percent



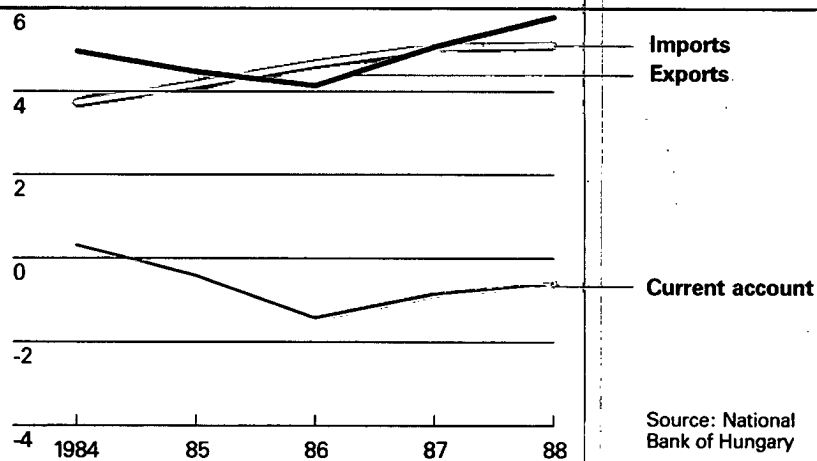
Source: L.W. International Financial Research, Inc.

# HUNGARY

## 3. Selected External Financial Indicators

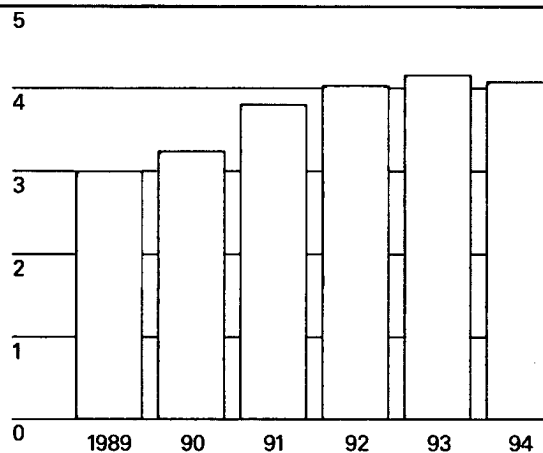
### Hard Currency External Accounts, 1980-88

Billion US \$



### Hard Currency Debt Service,<sup>a</sup> 1989-94

Billion US \$



<sup>a</sup> Principal and interest

markets capable of stimulating more efficient use of resources and easing capital constraints on growth. These measures include reorganizing the banking system and introducing new financial instruments, creating a new tax system, expanding the scope of private and foreign investment, and establishing bankruptcy procedures. The leadership also has taken steps toward market-based wages and prices, but is moving slowly in these areas because domestic competition is still weak. Because many reform measures are either still being phased in or have not been implemented as planned, a brief summary of their progress will help clarify the current obstacles to change and the areas in which Western assistance would have the greatest impact in furthering the reform process.

### **Financial Sector**

Since the government reorganized the banking system in January 1987—establishing a two-tier banking system composed of a central bank and independent, competing commercial banks—commercial banks have gradually gained greater autonomy. At the same time, commercial bank activity is limited by a shortage of trained personnel and by the austerity program and its accompanying tight monetary policy.

This year, additional steps have been taken to increase competition between banks. For example, restrictions on the deposit taking and credit activities of the banks have been eliminated. Commercial banks are now permitted to accept deposits from and to lend to individuals, while the National Savings Bank and savings cooperatives may offer banking services to enterprises. The National Bank still maintains a monopoly over foreign exchange transactions, but it may give it up in 1990.

Budapest has also encouraged the founding of other financial institutions, including joint Hungarian-foreign banks, which have carved out a niche servicing joint ventures and foreign companies participating in World Bank projects. It has also introduced new financial instruments, such as bonds and stocks. Bonds have been in use since 1983, but the securities market is still in its infancy, functioning more like a small trading club than a stock exchange.

Hungary probably will continue gradually to liberalize its financial markets, but the process will have a limited impact on capital flows in the near term because:

- The state still heavily influences investment decisions by controlling a significant share of enterprise income through taxes and subsidies.
- The new banks' ability to extend loans is limited because of their small capital base, large reserve requirements, and the high refinancing rate charged by the National Bank. Because of Hungary's weak balance-of-payments position and the need to dampen domestic demand and imports, Hungarian officials appear determined to keep tight control on commercial banks to avoid an inflationary credit surge. Financing the state budget deficit also claims a sizable share of the financial sector's resources.
- A shortage of skilled bank managers and inadequate telecommunications and computer networks hinder the expansion of banking operations. Banks also need to improve their internal accounting and auditing procedures and to develop means of evaluating investment projects and enterprise creditworthiness. This is difficult because, in an economy with an extensive subsidy system, a limited number of market-determined prices, and a nonconvertible currency, profits often fail to reflect the most efficient use of resources. In addition, most enterprises do not have adequate bookkeeping.
- The new banks have been saddled with many financially troubled customers who tie up their lendable resources, but they do not have adequate loan loss reserves to force these clients into bankruptcy and are likely to encounter resistance from elements of the political leadership if they try to do so. Hungarian economists are concerned that continued state support of insolvent companies and tight monetary policies are serving merely to preserve the existing industrial structure.

### **Subsidies, Taxation, and Budget Reform**

Heavy subsidization of industry, agriculture, and consumer prices, which in turn necessitates excessive taxation, is at the heart of the economy's structural problems. State

subsidization of Hungarian enterprises has accounted for about a quarter of budget expenditures throughout the 1980s and represents the equivalent of about 20 percent of gross domestic product (GDP). This system has had a devastating impact on economic performance by supporting loss-making enterprises and penalizing successful companies (see inset and table 2).

In 1988, Hungary introduced a tax reform in an effort to increase financial discipline and reduce the role of the central government budget in financial intermediation. The changeover from a complex system of turnover and other taxes to a value-added tax and personal income tax was intended to end the discriminatory tax treatment of private enterprises and reduce an extremely high corporate tax rate both by broadening the tax base and by shifting taxation from production to consumption.

Thus far, the tax reform has fallen short of these objectives. Enterprises have ended up shouldering most of the burden of personal income taxes, as they were required to compensate employees for the new taxes they had to pay. Although the profit tax rate now has been reduced to 54 percent, the state still claims the bulk of enterprise profits through various other assessments. Raba, a manufacturer of truck axles and one of Hungary's top exporters to the West, has complained publicly about the unreasonably large share of company profits—about 80 percent—that continues to be siphoned off by the government.

In contrast, the personal income tax is a relatively small proportion—some 12 percent—of the population's earnings from wages, interest, and dividends because of a wide range of exemptions and allowances. Personal tax rates are sharply progressive, however. The top tax rate has been lowered from 60 percent in 1988 to 52 percent in 1989, but it almost certainly has an adverse effect on personal initiative.

Recognizing the need to further reduce corporate taxation and state involvement in the economy, the government has called for reform of the budget. Minister of Finance Laszlo Bekesi has said the fundamental goal should be to reduce the budgetary redistribution of incomes from the current 60 percent of GDP to 40 to 45 percent by 1992. Subsidies, for example, would be slashed from their current level of over 200 billion forints to about 100 billion forints—a significant

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### **Subsidies**

*Subsidies have accounted for between 26 and 29 percent of state budget expenditures in recent years. Such support is extended by various means, including investment grants, the writeoff of tax and debt liabilities, and direct and indirect subsidies, of which there are least five different types:*

- *Consumer subsidies are paid mainly on basic goods including some foods, energy, medicines, utilities, and transport.*
  - *CEMA price equalization subsidies are granted to enterprises in order to make it profitable for them to fulfill state agreements with the CEMA countries. Metallurgy and food processing are the main beneficiaries of this support.*
  - *Producer price subsidies are provided mainly when producer prices do not cover actual costs because of price setting by the government. The subsidy is determined by the relationship between the administered price and the production cost of a given commodity, irrespective of the profitability of production.*
  - *Agricultural policy supports fall into two major categories: general production subsidies, including subsidies for milk production and the raising of cattle, sheep, and goats, and subsidies to farms in agriculturally disadvantaged areas.*
  - *Import subsidies apply to a few basic commodities, mainly energy products, whose domestic prices are administratively fixed at a lower level than the actual import price.*
- 

reduction, especially if the annual inflation rate remains above 15 percent. Even with lower subsidies, such a major cut in budgetary expenditures will be difficult, given the pressing need to modernize Hungary's infrastructure and the growing demands for a better social welfare net.

**Table 2**  
**Hungary: Central Government Subsidies, 1983-88**

*Billion forints*  
 (except where noted)

	1983	1984	1985	1986	1987	1988
<b>Total</b>	<b>164.4</b>	<b>159.9</b>	<b>169.3</b>	<b>201.5</b>	<b>217.4</b>	<b>215.3</b>
Producer subsidies	97.8	106.4	119.1	141.7	150.7	156.3
Consumer price subsidies	66.6	53.5	50.2	59.8	66.7	59.0
Share of budget expenditures (percent)	28.9	26.1	26.2	27.7	27.3	25.0 <sup>a</sup>

Sources: Hungarian Statistical Yearbooks, East European Markets. <sup>a</sup> Estimate.

### Ownership and Privatization

Although many legal restrictions on private enterprise have been lifted, and entrepreneurship is acknowledged as a key element for economic recovery, privatization efforts and Hungarian entrepreneurs still face many obstacles. The key problems include heavy taxation and bureaucratic redtape, limited access to commercial loans and hard currency, an uncertain investment climate, and an inadequate infrastructure, particularly the availability of office space, telephones, and computers.

Since Budapest began legalizing an ever-widening range of private-sector activities in 1982, this sector has been the most vibrant part of the economy, outperforming the state sector in job creation, output growth, and productivity. It has helped Hungary avoid a severe decline in economic growth and has improved the supply of many consumer goods and services. Recent studies of the private sector by Hungarian and Western researchers show that:

- The private sector, including production from private agricultural plots, accounted for 14.3 percent of GDP in 1988, according to official Hungarian figures. Furthermore, unreported economic activity may equal as much as 15 percent of official GDP.
- Three out of four working Hungarians participate at least part time in the private sector, and the work force devotes about one-third of its total worktime to private activities.
- Approximately 2,000 small-scale cooperatives, each with fewer than 100 employees, essentially function as private enterprises. Many are small industrial or service operations associated with large agricultural cooperatives or state farms.

- Agriculture is the largest private-sector employer, and private producers are the primary suppliers of such key food items as pork, eggs, potatoes, vegetables, and fruit.
- The private sector accounts for about 95 percent of housing construction and some 60 percent of consumer services, such as restaurants, automotive repair work, and beauty shops.
- The private retail sector, with close to 60,000 employees and about 40,000 outlets, accounts for 15 to 20 percent of all retail sales.

The private sector received a significant boost last January with the introduction of a new enterprise law that goes well beyond other comparable legislation in Eastern Europe in three broad areas:

- Expanding opportunities for private investors by allowing Western ownership forms, including limited liability and joint stock companies, and employment of up to 500 workers.
- Reducing discrimination against the private sector with a more uniform corporate tax system.
- Liberalizing foreign investment by permitting wholly foreign-owned ventures.

The National Assembly passed additional legislation in May 1989 governing the conversion of state enterprises to joint stock companies. Such companies now have the right to sell shares—even majority shareholdings—to Hungarian citizens and companies as well as to foreign investors.

Hungary has also passed the most liberal joint-venture laws in the East Bloc in order to encourage foreign investment and gain access to the Western capital, managerial expertise, and technology needed to modernize its economy. To attract investors, joint ventures in priority sectors—including chemicals, automotive components, metallurgy, and food processing and packaging—are exempt from taxes for five years.

The tax breaks and more liberal political climate have encouraged an increasing number of foreigners to establish joint ventures. By the end of 1988, there were 288 such ventures, with \$320 million in paid-in capital, more than any other East European country has attracted. Budapest claims an additional 300 ventures have been formed so far this year, but it is unclear how many of these will actually get off the ground. Hungary is even having some success attracting foreign companies to invest in its troubled enterprises. In August 1989, for example, two West German steel companies took over a 60-percent share of an ailing steel mill with a capital injection of 30 million deutsche marks (\$15.2 million), according to Hungarian press reports. In fact, Hungarian officials claim foreigners invested \$17.8 million in metallurgical ventures through the end of June and have signed letters of intent on projects amounting to another \$120 million. They estimate at least \$1 billion would be needed, however, to bring this sector up to Western technological standards.

To encourage an even larger inflow of funds, Hungary recently liberalized its property laws. As of last July, joint ventures, limited companies, and public limited companies in which foreigners hold shares may buy real estate without any restrictions, even if Hungarian ownership is no more than 1 percent. Wholly foreign-owned companies may also purchase real estate, but only with a government permit.

Despite the dramatic rolling back of legal restrictions on the private sector, private ownership of industrial assets probably will not expand rapidly. The conversion of state enterprises to joint stock companies will be difficult because many important issues, such as how to value enterprise assets for creating shares, remain unresolved. There are numerous other obstacles as well. These include:

- An unfavorable climate for private investment in stocks and bonds. Hungary's fledgling bond and stock markets have had trouble attracting private investors, mainly

because they are unable to offer dividends high enough to compete with rising inflation and the interest rates offered on bank deposits. Double-digit inflation and lack of confidence in the government's management of the economy are also encouraging consumer spending at the expense of personal saving and investment.

- Continuing state control of joint stock companies. The conversion law provides only for a minimum 20-percent state ownership in state companies that have become joint stock companies. The bulk of shares, however, will be retained by state and quasi-state organizations, such as the social security fund, municipalities, and insurance companies, because there are few other potential owners possessing the necessary capital. Such shareholders may not have the same overriding interest in enterprise profits as private shareholders and will be more amenable to government influence than private investors.
- Checks on private ventures. Private entrepreneurs—and state enterprises as well—must contend with excessive bureaucratic redtape and a still onerous tax burden that limits the resources available for expansion. Private businesses have much more limited access to commercial loans and hard currency for imports of Western capital goods than state companies and lack the “subsidy safety net” provided to state enterprises and large cooperatives. Occasionally, even when they do have access to funds, they find the terms too stringent. The National Association of Private Entrepreneurs has complained, for example, that a World Bank loan for private enterprise is attracting few borrowers because the 22-percent interest rate set by the National Bank, which is administering the loan, is too high. In addition, Hungary does not have an adequate support network of accountants, lawyers, bankers, and other professionals experienced in providing services and training to small businesses.

Despite these obstacles, private and joint ventures are certain to contribute increasingly to national and personal income growth, not least because the entrepreneurial drive is still alive in Hungary. Foreign investment and privatization of state companies, however, are not—as many in the Hungarian leadership appear to believe—fast-acting cures for the economy's deep-seated structural problems.

They cannot produce significant economywide restructuring in the near term because of continuing state control over most large companies and because of the long leadtime needed to negotiate and set up joint ventures with foreign partners.

### **Bankruptcy**

About 170 bankruptcy proceedings have occurred since the Hungarian parliament approved bankruptcy legislation in September 1986, but almost all have involved small cooperatives or private firms. Major state companies are still largely immune from the bankruptcy threat because the leadership fears that massive layoffs will precipitate a wave of labor unrest and that closing down some of Hungary's biggest loss-makers could cause shortfalls in the supply of certain goods for domestic consumption as well as for export. These fears are not unreasonable; in 1986, the five enterprises with the largest losses accounted for nearly 10 percent of industrial output, according to a Hungarian press report.

Budapest thus continues to bail out troubled state companies instead of liquidating them. Successful bailouts are rare, however, and a number of firms—the Ganz-Mavag transportation equipment company is an example—have been rescued three or more times over the past decade. Poor results are due in part to the fact that the management of these firms is seldom replaced, sometimes because of personal influence, but also because of a shortage of qualified personnel. Moreover, government authorities often fail to follow up to assure that rescued firms are making a concerted effort to restructure their operations.

The extent to which the government will accelerate restructuring and force more bankruptcies over the next several years depends on the leadership's ability to ease social tensions by both stimulating new plants and employment in areas where smokestack industries are concentrated and providing adequate unemployment benefits. The government currently has only limited funds for unemployment insurance, retraining programs, and investment promotion as well as public works projects and other job creation schemes in depressed regions. Out of 20,000 unemployed—less than 0.5 percent of the work force—in May 1989, only about 3,000 were receiving unemployment assistance, which requires at least 18 months' employment

in the state sector during the preceding three years. The expense of a more comprehensive program could be substantial. Hungarian officials estimate 150,000 to 200,000 people would be thrown out of work if restructuring efforts were vigorously pursued, a reasonable estimate if, as Finance Minister Bekesi claims, Hungarian factories employ about 20 percent more workers than they actually need.

### **Wages and Labor Productivity**

Budapest faces a dilemma in trying to reform wages. On the one hand, it wishes to avoid wage push inflation; on the other hand, it wants to encourage individual initiative, improve productivity, and move away from providing basic necessities such as housing, food, heat, and transportation at heavily subsidized prices. Since January 1989, enterprises have been free to determine individual earnings subject to a performance-related ceiling on their total wage bill—a system that still allows a modicum of central control until market forces are strong enough to discourage enterprises from granting excessive wage increases. The parameters of wage policy are set through a collective bargaining process that involves representatives of the official trade union, the Chamber of Commerce, private business, cooperatives, and the government. Wage increases above recommended levels are subject to prohibitory taxes, thereby effectively limiting the scope for wage differentiation. The leadership has, however, been gradually reducing such tax penalties as well as granting greater wage-setting freedom to firms that meet certain performance criteria.

Meanwhile, most firms have had few incentives to use labor efficiently because of the limited differentiation of wages and artificially low overall labor costs. Workers have also lacked incentives for greater effort on their state jobs because declining real wages have forced nearly three-fourths of the work force to seek part-time employment in the private sector, where wages are not controlled, to maintain their standard of living. Widening income differentials between state and private jobs have aggravated social tension and hurt productivity in the state sector. The personal income tax introduced in 1988 was intended to narrow these differentials, but tax evasion is probably common. Hungary's precarious financial situation probably

**Table 3***Percent change over previous year***Hungary: Annual Real Wage, Income, and Consumption Growth**

	1981	1982	1983	1984	1985	1986	1987	1988 <sup>a</sup>
Real wage per earner	1.1	-0.7	-3.2	-2.4	1.3	1.9	-0.4	-6.5
Real income per capita	2.9	0.9	1.1	1.1	1.9	2.3	0.7	-2.0
Per capita consumption	2.6	1.3	0.7	1.4	1.5	2.2	3.9	-4.2
Consumer price index	4.6	6.8	7.4	8.2	6.9	5.4	8.5	15.7

Sources: Hungarian Statistical Yearbook, National Bank of Hungary Quarterly Review.

<sup>a</sup> Preliminary.

will require future cuts in real wages and consumption, which will make it even more difficult for enterprise managers to command stricter labor discipline and higher productivity (see table 3 and figure 4).

Inadequate funds and mechanisms for retraining and relocating large numbers of workers have further slowed efforts to boost labor productivity and to restructure industry. In 1989, about 72 percent of job applicants were unskilled laborers or semiskilled workers, whereas 89 percent of the reported vacancies called for special skills. Hungarian state industry is unable to fill vacancies for skilled labor because many workers with advanced technical training can earn more in private-sector pursuits such as cab driving. According to Hungary's National Technical Development Board, every third technical university graduate earns a living in a nonrelated profession. Workers' attachment to their places of residence and serious housing shortages have been additional obstacles to labor mobility. To encourage more mobility, policymakers must eventually allow greater wage differentiation, raise wage levels in the state sector, expand retraining programs, and improve the housing supply. Housing construction may slow, however, because the government has had to terminate its heavily subsidized housing loan program because of budgetary pressures and financial reforms.

Productivity increases probably are also being hampered by the population's declining health. The deteriorating economic situation, which has forced more people to work longer hours to make ends meet, and crowded living conditions have taken their toll. Statistics show increasing

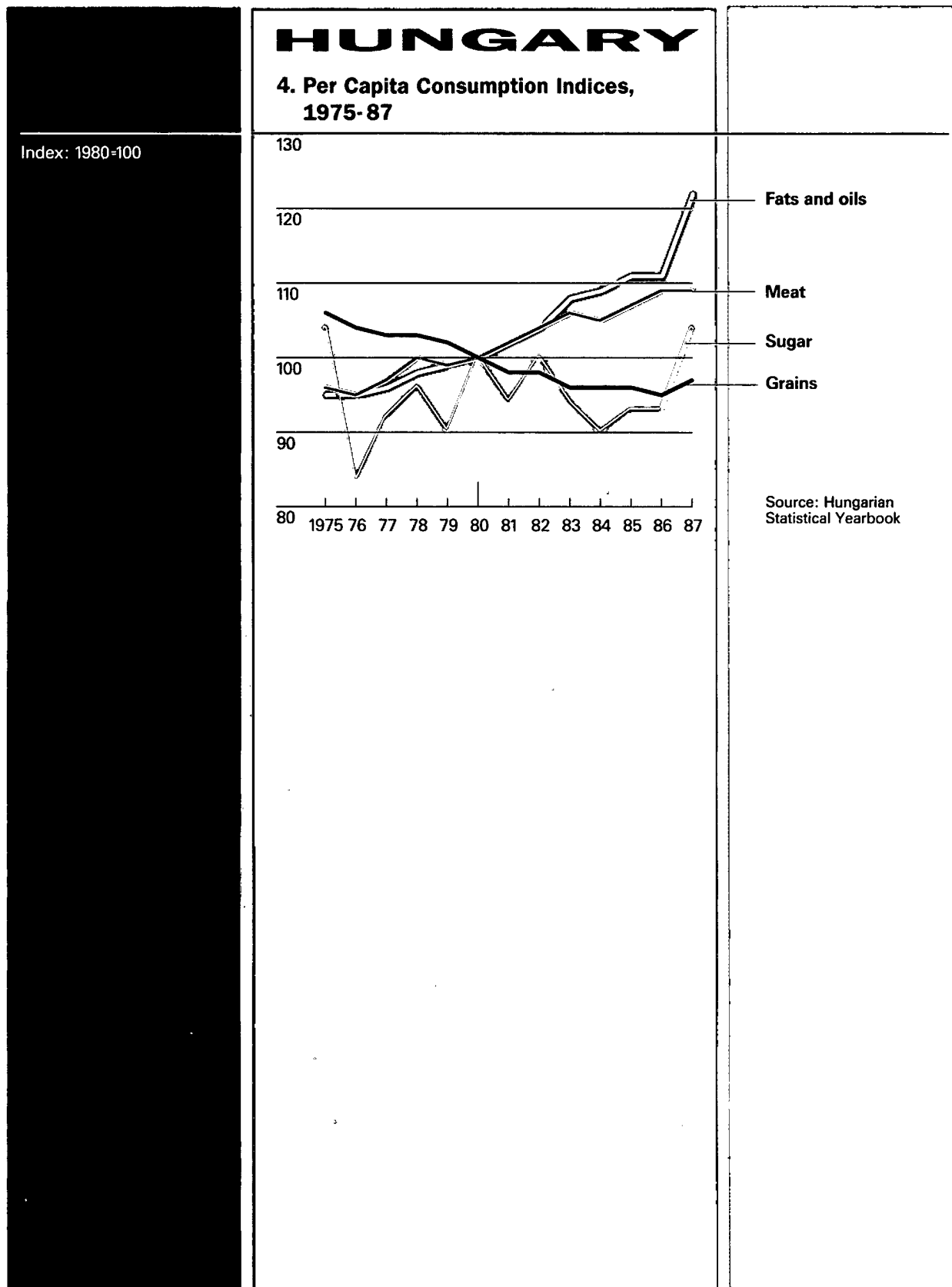
incidences of heart disease and alcoholism as well as a significant rise in the mortality rate of men between the ages of 30 and 49. Moreover, the decline in the health of the population has not been matched by a corresponding improvement in state health services. Thus, the cost to the economy of absenteeism and lengthy illnesses is likely to rise in coming years (see figure 5).

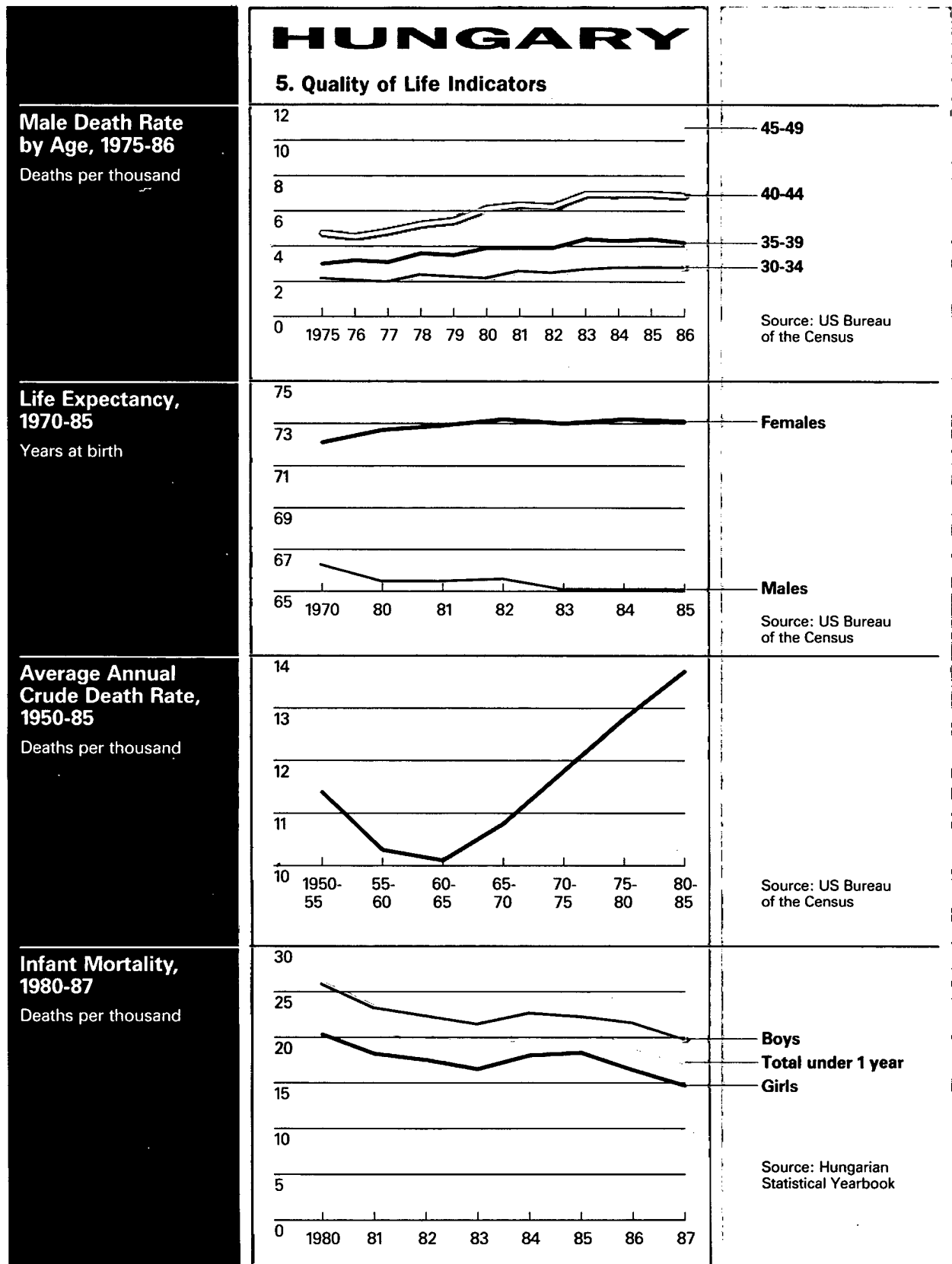
**Gradually Moving Toward Market Pricing**

Although Hungary has significantly reduced direct administrative controls over prices, it still has a long way to go until market supply and demand are the preeminent factors in price determination. In the absence of a competitive goods market, most of Hungary's many price reform efforts over the past 20 years have focused on trying to simulate how market-determined pricing would work. In practice, the various price mechanisms quickly grew too complicated and contributed little to cost sensitivity. Only in recent years have Hungarian policymakers attempted to establish appropriate wholesale prices relative to retail prices and to end the subsidization and administrative setting of consumer prices along with other reforms designed to increase competition.

Consumer goods currently are subject to four types of pricing regulation:

- Administered prices. These cover the 17 percent of consumer goods that are subsidized, including household energy, transportation, milk, some basic food items, and pharmaceuticals.





- Prices subject to advance reporting. Another 13 percent of prices cannot be raised without prior reporting to the Price Office, which can deny or limit planned increases.
- Negotiated prices. Only 7 percent of prices are determined through negotiations between the government and enterprises. This arrangement allows government intervention in markets that are dominated by only a few firms or where other problems limit competition.
- Free prices. The remaining 63 percent of prices are subject only to the Import Pricing Rule, which specifies that prices should not exceed the landed cost of comparable imports, and the Law of Unfair Economic Practices, which is designed to prevent exploitative behavior by producers and retailers.

Budapest intends to increase gradually the share of consumer goods in the quasi-free-price category to about 70 percent by 1990, primarily by reducing the coverage of the advance reporting category. The government maintains the prerogative to intervene in price formation, however, because of concern about keeping inflation and social tensions in check, and it appears to still exercise considerable influence over prices through consultations with Hungary's largest producers.

#### **Marketizing International Trade**

Hungarian policymakers recognize that the economy must be better integrated into world markets in order to expose Hungarian producers to greater competition, accelerate industrial restructuring, and ultimately improve Hungary's ability to service its foreign debt. Last January, the government took the first steps toward a freer import regime, and, a few months later, a government committee under state minister and party chairman Rezso Nyers recommended reducing trade with Eastern Europe and placing trade with the Soviet Union on a hard currency basis. Although Hungary is not likely to withdraw from CEMA in the near term, it undoubtedly will take a more selective approach to participation. These steps alone, however, will not enable the Hungarian economy to shift trade rapidly toward the West, because shortages both of hard currency for imports and of competitive goods for export will persist into at least the mid-1990s.

**Import Liberalization.** This year, the government abolished import licenses and quotas on products—mainly machinery and spare parts—representing some 40 percent of the value of hard currency imports. Although imports of capital goods and spare parts increased by 20 to 25 percent in the first half of 1989, the Hungarian Chamber of Commerce alleges that technological development is still being hindered by high import tariffs—often in the 35- to 50-percent range—on advanced, high-technology products. In 1990, the government plans to free an additional 20 percent of imports, including metallurgical products, chemicals, and basic inputs such as wool, leather, and wood for certain light industry branches. According to a Trade Ministry official, it wants 85 percent of convertible currency imports liberalized by the end of 1991. Raw materials and energy will not be included, probably because Hungary fulfills its needs in these areas mainly through Soviet imports and because its energy sector is integrated into CEMA electricity grids as well as CEMA oil and gas pipeline networks.

**The CEMA Connection.** The idea of shifting trade with the Soviet Union—Hungary's largest trading partner, accounting for about 30 percent of total trade—to a hard currency basis and world prices stems from Hungarian frustration that the current system of CEMA trade and cooperation is impeding restructuring and that its reform is not likely in the foreseeable future. The Soviets are studying this option, but no firm commitment to a new trade regime has been made on either side.

There is much debate among Hungarian officials over whether the transition to hard currency accounting will pay off. Although it might attract Western joint-venture partners interested in using Hungary as a base for exporting to the Soviet Union, it probably would cause a shortrun deterioration in Hungary's hard currency trade balance. The Soviets, for example, probably would be less willing to purchase Hungarian goods, particularly machinery, that are below Western standards for hard currency, leading to a fall in Hungarian industrial production and employment. It is impossible to determine exactly how much Hungarian exports would fall, but the Ministry of Trade estimates losses would total \$800 million to \$1 billion, while the

Hungarian Chamber of Commerce, which is opposed to the proposed change, puts the figure at \$2.0-2.2 billion. In any case, the transition to hard currency trade will not occur before 1991 at the earliest, when a new five-year planning period starts in Hungary and in the Soviet Union.

### **Prospects for Further Reform**

A relatively broad consensus appears to be forming among party reformers and some key opposition parties—the groups that appear to be driving current policy discussions—that Hungary has no alternative to moving toward a market economy and becoming more integrated into the world economy. There is no agreement, however, on how far and how fast to proceed with reforms and how to balance competing macroeconomic goals. Hungarian economists have been debating, for example, whether Hungary can best preserve its solvency and promote an economic recovery through austerity measures or through a selective growth strategy. In response to further deterioration in Hungary's economic performance in the first half of 1989, the leadership is currently preparing at least three different options for a new three-year economic program. These options—basically a continuance of current policies, a faster reform program, and a contingency plan in the case of a rescheduling—probably will be presented to the parliament this fall and may form the basis of negotiations with the IMF over new assistance.

The leadership probably will not implement a reform program of the scope it really needs until after multiparty parliamentary elections scheduled to take place by June 1990. In fact, the "three-year" program probably will be short lived because the next government undoubtedly will want to formulate its own plan. Most of the critical reforms needed to put the economy on a sounder footing, such as cutting subsidies and allowing insolvent state enterprises to fold, are measures that only the Hungarian leadership itself can implement. In these areas, the pace of reform is largely driven by Hungarian political realities, in particular the strength of the leadership and its political will to enforce unpopular policies. As the protracted negotiations with the IMF on a renewal of the standby credit illustrate, the leadership shows little enthusiasm for hard decisions in an election year.

In the runup to the election, the leadership probably will employ only stopgap measures to stem economic deterioration, while trying to consolidate and broaden the reforms it has already initiated. The leadership, however, probably will give more attention to attracting foreign investment than to phasing out subsidies and insolvent enterprises. Budapest appears concerned that workers, whose wages have not kept pace with prices, will take to the streets if also faced with widespread unemployment. As much as one-quarter of the population already lives at or near the poverty level, according to official Hungarian statistics. The number of strikes will certainly increase over the next several years, but so far workers have remained largely apolitical and have not tried to organize a nationwide labor challenge to the leadership.

The economy's fundamental weaknesses are so deep seated—large foreign debt burden, limited hard currency earning potential, and heavy dependence on Western imports—that, even if the leadership accelerates reform, prospects for improved economic performance and living standards will be limited at least into the mid-1990s. Loose fiscal and monetary policies this year will add to inflationary pressures and make it more difficult to pursue decentralizing reforms of wages, prices, and imports in 1990.

### **What the West Can Do**

One of the most significant contributions the West can make to Hungary's economic well-being during this difficult transition period is to provide technical and managerial expertise in a host of areas. These include:

- Developing capital markets and a service infrastructure for the private sector.
- Improving enterprise management.
- Establishing foreign sales networks.
- Retraining large numbers of workers.
- Creating a tax system that neither stifles initiative nor discourages investment.

Lowering barriers to Hungarian exports in Western markets would also be beneficial, and the costs to the West should not be excessive. The low competitiveness of many Hungarian exports, particularly in the manufactured consumer goods, engineering, and food-processing sectors, probably would constrain their growth.

In addition, Budapest is looking to Western governments to encourage foreign investment in Hungary and may in the future need to seek some form of debt relief. Over the past year, Hungarian Government officials have publicly discussed various options, including rescheduling and debt-equity swaps, to ease the country's financial burdens. Commercial banks, which hold almost 90 percent of Hungary's debt, are not willing to grant interest rate reductions or debt writeoffs, however, as they have their own profitability to consider. Thus, Budapest has so far sought financial assistance in the form of IMF and World Bank loans and Western-backed government loans to bolster its creditworthiness and maintain access to commercial credits. At some point, Hungary may be forced to seek emergency bridge loans from Western governments and the Bank for International Settlements, as it did in 1982. Under such circumstances, or in the case of other forms of financial assistance, the West can help promote reform and economic recovery by tying new funds to specific projects or performance to ensure that they are used for their intended purposes. The West can also promote modernization of the Hungarian economy more effectively through debt-equity swaps, which could help promote a transfer of Western technology and managerial skills, than through untied credits.